SUPREME COURT, U. S.

FILED

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IN THE

Supreme Court of the United States

October Term, 1968

No. 1302

UNION PACIFIC RAILROAD COMPANY,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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UNION PACIFIC RAILROAD COMPANY,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Petitioner prays that a writ of certiorari issue to review the decision of the United States Court of Claims granting respondent's motion for partial summary judgment and denying petitioner's motion for partial summary judgment.

Opinion Below

The opinion of the United States Court of Claims is reported at Ct. Cls. , 401 F.2d 778 (Ct. Cl. 1968), and is reprinted in Appendix A, *infra*, pp. 1a-15a.

Jurisdiction

The decision of the United States Court of Claims was entered on October 18, 1968. Petitioner's motion for rehearing was denied on January 24, 1969. The jurisdiction of the Court is invoked under 28 U.S.C. § 1255(1).

Questions Presented

1. Whether, under the provisions of the World War II Excess Profits Tax Act, petitioner is entitled to include in equity invested capital for purposes of computing its excess profits tax credit, the fair market value of its stock exchanged in 1907 through 1914, in exchange for, and upon conversion of, certain bonds sold by it in 1901 and 1907.

2. Alternatively, whether petitioner is entitled to include in said equity invested capital the fair market value of the bonds as of the time of their conversion.

Statutes and Regulations Involved

The pertinent portions of the statutes and regulations involved are as follows:

Internal Revenue Code of 1939:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 718 [as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974, and amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798].

EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the

time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(1) for determining earnings and profits;

* * *

(26 U.S.C. 1952 ed., Sec. 718.)

Treasury Regulations:

REGULATIONS 112, SECTION 35.718-1,

DETERMINATION OF DAILY EQUITY INVESTED CAPITAL —MONEY AND PROPERTY PAID IN.—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. The terms "money paid in" and "property paid in" do not include amounts received as premiums by an insurance company subject to taxation under section 204. For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. If the property was disposed of after February 28, 1913, and before such taxable year, such unadjusted basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913; if the property was disposed of before March 1, 1913, its unadjusted

basis shall be considered to be its fair market value at the time paid in.

If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. If the stock had no established market value at the time of the exchange, the fair market value of the assets of the company at that time should be determined and the liabilities deducted. The resulting net worth will be deemed to represent the total value of the outstanding stock. In determining net worth for the purpose of fixing the fair market value of the stock at the time of the exchange, the property paid in for such stock shall be included in the assets at its fair market value at that time.

If stock having no established market value is issued for intangible property, and it is necessary to determine the fair market value of such property, the following factors, among others, may be taken into consideration in determining such value: (a) The earnings attributable to such intangible assets while in the hands of the predecessor owner; and (b) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock should file with its return a full statement of the facts relating to such valuation.

* * *

(26 C.F.R., Part 35, Section 718(1943 Supplement).)

Statement of the Case

In 1901, petitioner issued $100 million in ten-year four percent bonds which were convertible at the option of the holder into $100 par value common stock. Petitioner received cash in the face amount of said bonds on issuance. During the years 1901 through 1907, petitioner issued 994,500 shares of its common stock on conversion of $99,450,000 principal amount of these bonds.

In 1907, petitioner issued $73,762,000 in twenty-year four percent bonds which were convertible at the option of the holder into $100 par value common stock at the rate

of one share of stock for each $175 face value of bonds. Petitioner received cash in the face amount of said bonds on issuance. During the years 1908 through 1914, petitioner issued 268,153 shares of its common stock on conversion of $46,926,775 principal amount of these bonds.

At the times of conversion of the bonds of both issues, the fair market value of the stock issued and the fair market value of the bonds greatly exceeded the par value of said stock and the face amount of said bonds.

In Counts XXIX and XXX of its first amended petition in the Court of Claims, petitioner asserted that, in computing its equity invested capital, it should have included the fair market value of said stock in money or property paid in for stock and claimed an additional $106,375,300, the difference between the fair market value of the shares when issued and their par value. Only par value of the shares had been allowed by the Commissioner.

On April 2, 1968, respondent filed a motion for partial summary judgment with respect to Counts XXIX and XXX of petitioner's first amended petition, and on May 10, 1968, petitioner filed its own motion for partial summary judgment with respect to these two counts. On October 18, 1968, the Court of Claims filed an opinion granting respondent's motion and denying petitioner's motion. On November 18, 1968, petitioner filed a motion for rehearing and reconsideration or, in the alternative, for further testimony, which motion was denied by the Court of Claims by order dated January 24, 1969.

Reasons For Granting The Writ

1. The decision of the Court of Claims is contrary to and repudiates the Code and Regulations it purports to apply.

In its motion for summary judgment below, respondent contended that Section 718(a)(1) applied, the money originally paid for the bonds is the determinative factor, the

subsequent conversion of the bonds into stock was economically immaterial, and that equity invested capital must be computed under Subsection 718(a)(1) as "money previously paid in for stock." Petitioner's position was that the conversion of the bonds constituted "property" paid in under the precise terms of Subsection 718(a)(2) and the bonds being property, that statute and Section 35.718-1 of Treasury Regulations 112 required that the amount included in equity invested capital must be the "fair market value of such stock at the time of its issuance," or the fair market value of the bonds paid in at such time. In the further alternative, petitioner contended that the cost basis of the bonds to the converting bondholders must be so included.

The Court below, in its opinion dated October 18, 1968, recited that petitioner's contentions conform completely and exactly with the requirements of the Revenue Code and Treasury Regulations but refused to apply said provisions in this case. In fact, the Court repudiated the very provisions it purported to apply. Although it agreed that Treasury Regulations 112, Section 35.718-1, is applicable, the Court went on to hold that ". . . for all practical purposes, the fair market value of the stock and of the bonds at the time of conversion was immaterial." Yet Section 718(a)(2) of the Code mandates to the contrary as do said Treasury Regulations! Section 718(a), by its terms, specifically precludes such an "interpretation" which is exactly contrary to its precise terms! The statute is clear and unambiguous. It provides for "money previously paid in" *or* "property (other than money) paid in." This precise distinction leaves no room for *treating* property as if it were money. In the instant case the money was paid for bonds, bonds were paid in for stock—bonds are not money, they are property! The statute does not provide for money or its equivalent. It says only "money" *or* "property."

Petitioner submits that the construction of the applicable law adopted by the Court of Claims is erroneous. This Court has held many times that a taxpayer need only bring

itself within the literal terms of a revenue law in order to prevail and that equitable considerations do not control the application of the tax laws. In *Lewyt Corporation* v. *C.I.R.*, 349 U.S. 237 (1955), Mr. Justice Douglas stated, at p. 240:

> But the rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. See *Bullen* v. *Wisconsin*, 240 U.S. 625, 630. * * *

2. The Court of Claims, contrary to all judicial precedent, erroneously held that the bonds were not to be considered property in this case.

In its opinion (Appendix A) the Court below agreed that bonds are property but held that they cannot be considered property in this case. Every case decided under Section 718(a) of the Code involving bonds has held that they are property and not money. The fact is that money was not paid in for stock, bonds were and as bonds are property, Section 718(a)(2) is the applicable subsection. To ignore the issuance of the bonds and treat the entire problem as if the bonds had never existed is to construct a fiction that defies all economic reality.

The excess profits tax acts are "supersurtax statutes" which are highly technical and intended to be carefully applied as written. Cf., *Commissioner* v. *Acker*, 361 U.S. 87 (1959); see Mertens, *Law of Federal Income Taxation*, Vol. 7A, Section 42.01 (1955 ed.). Elementary justice requires that they not be distorted so as to thwart taxpayers who literally and technically comply with their terms.

In the instant case, the statute is clear, specific and unambiguous. The Court below erred by refusing to apply it and instead substituting its own definition of equity invested capital. This is a province reserved solely to the Congress which alone can exercise such a legislative function. *The Maltine Co.* v. *Commissioner,* 5 T.C. 1265 (1945); *Hanover Bank* v. *Commissioner,* 369 U.S. 672 (1962), at pp. 687-688; *Fabreeka Products Co.* v. *Commissioner,* 294 F.2d 876, 879 (C.A. 1st, 1961). The Court of Claims, itself, has said in *A. P. Sullivan Corp.* v. *United States,* 381 F.2d 399 (Ct. Cls. 1967), in reversing a prior decision (at p. 403): "And absent specific statutory authority sanctioning a departure from the principle, it may only be said of [the prior decision] that it achieved a result that was more equitably just than legally correct." Yet in the instant case, that Court refused to apply its own precise prior holding.

3. The decision of the Court of Claims is in direct conflict with a decision of the United States Court of Appeals, First Circuit.

In its opinion of October 18, 1968, the Court below held that the cases cited by petitioner as authority for the proposition that the bonds were property (not money) paid in for stock under Section 718 are inapplicable because they did not involve convertible bonds, and were debts of the taxpayer (Appendix A, pp. 8a and 9a).

In *Walsh Holyoke Steam Boiler Works, Inc.* v. *C.I.R.,* 160 F.2d 185 (CA 1st 1947), relied upon by petitioner in this case, bonds of the taxpayer, though not by their terms convertible, were exchanged for stock of the taxpayer. In that case the First Circuit held that the taxpayer's equity invested capital was to be determined by reference to the *value* of the bonds at the time of the exchange for stock, and *not* their cost or purchase when originally issued. The First Circuit stated at p. 188 that, "a corporation's obligations, when turned in for stock, may be regarded as prop-

erty within the meaning of §718(a)(2)." Contrary to the decision in the instant case as to Congressional intent, the First Circuit Court held that:

> We see nothing in the language of §718 or in the underlying purpose of the excess profits credit to warrant the favorable tax result contended for by petitioner. If such had been the intention of Congress, it would have been a simple thing to provide that, where bonds or notes of a debtor corporation are turned in for stock, the face amount of the indebtedness, plus unpaid interest, is to be carried into the corporation's equity invested capital.

Further, to distinguish between debt securities on the basis of whether or not they are convertible by their terms is to make a distinction without a difference. The statute makes no such distinction. *Bonds are property, be they convertible or not.* In *Walsh Holyoke* the Court of Appeals also noted that the cost *basis* of the bonds contributed is the proper criterion. See discussion of the alternative argument, infra, pp. 12-13, and that precise application of the statute as written is mandatory.

4. The Court of Claims erred in refusing to even consider the economic ramifications of the conversion of the bonds as required by decisions of this Court.

In the Court below, petitioner contended that the conversion of the bonds into stock, which thus converted debt into equity, had the effect of contributing to and increasing the going concern value of petitioner in an amount to be measured by reference to the excess of the fair market value of the stock or of the bonds over the principal purchase price. It was never contended that such "going concern value" is precisely equal to the amount of such excess. The Court, however, dismissed the contention on the authority of *LaBelle Iron Works* v. *United States,* 256 U.S. 377 (1921) which prohibited the inclusion of *unrealized appreciation* in equity invested capital. This result, however, completely

ignores the point that the *conversion was the realization.* It begs the issue that the rule of *LaBelle* precludes consideration of the proof that *LaBelle* does not apply and going concern value was in fact realized by purchase. *Kimball Laundry Co.* v. *United States,* 338 U.S. 1 (1949).

In this context it is error to hold that Congress never intended the result contended for by petitioner. The statute itself is the primary indication of Congressional intent and it supports petitioner's contention. No other reference to Congressional intent is cited in the decision and there is none. Thus, the Court below has propounded its visceral reaction to the argument as the intent of Congress. This is not permissible in the judicial process.

All of the cases which were decided upon the teachings of the *LaBelle* decision have been carefully restricted to similar contexts.

The *LaBelle* case is not pertinent to the recognition of "going concern value" for excess profits tax purposes under the World War II statute. Further, it involved the World War I excess profits tax provisions while both *Walsh Holyoke* and the instant case involve the World War II excess profits tax act, two entirely separate and distinct statutes which differ considerably.

The World War I provisions were highly restrictive, and did not include money or other property borrowed in "invested capital." Furthermore, by statute, invested capital could not exceed the (a) actual cash paid in, or (b) actual cash value of tangible property paid in for stock as of *January 1, 1914 but in no case to exceed the par value of the "original stock or shares specifically issued therefor."* (Emphasis supplied.) Intangible assets purchased prior to 1917 with stock of a corporation could be included in invested capital, but not in excess of twenty per centum of the total shares of the corporation at the cash value at the time of purchase, and the amount included could not exceed the *par value* of the stock.

On the other hand, the World War II act contains no such restrictive provisions. There is no limitation to *par value* of stock in determining the consideration paid by a corporation. Rather, "property" paid in for stock is included "in an amount equal to its basis (unadjusted) for determining loss." Such basis, under Section 113 of the Code, is cost and, under Treasury Regulations 112, Section 35.718-1, this cost is "the *fair market value* of such stock (issued therefor) at the time of its issuance." (Emphasis supplied.)

Thus, the emphasis shifted in the World War II act to *values*. Mertens, *Law of Federal Income Taxation*, Volume 7A, Section 42.196 (1955 Ed.), points out that the World War II and Korean War Excess Profits Tax laws represent a major departure from the old World War I laws. (See particularly Mertens, *supra*, Section 42.196, Footnotes 79-84).

Apart from these statutory differences, the factual situations in *LaBelle* and the instant case are entirely distinct. *LaBelle* involved a transaction whereby the already equity capital holders (stockholders) unilaterally increased the equity capitalization of the corporation by issuing *additional* $100 par value shares in proportion to their former holdings. Since invested capital under the World War I act was determined by reference to cash paid in *and par value*, the effect was to increase arbitrarily invested capital in the amount of the par value of the additional shares. Except for this increase, nothing else changed. The old stockholders had the same interest in the same proportions as they had prior to the increase. It was admittedly a write-up to reflect the appreciation in value of a physical asset previously acquired by the taxpayer for cash.

In the instant case, there was no arbitrary write-up by petitioner which had no control over the bond conversions. The bondholders chose to release their lien and its underlying security in return for an equity interest in the earning

power of the petitioner junior to their previous creditor interest. The transaction was arm's length—there was a *quid pro quo*. The bondholders contributed their lien on the physical assets plus a creditor's charge on the earnings of the petitioner in exchange for an equity interest in the corporation and, hence, contributed additional going concern value to the enterprise. The petitioner acquired an asset (the increment in going concern value) and paid for this asset by the issuance of common shares in exchange therefor. See, *Omaha* v. *Omaha Water Co.*, 218 U.S. 180 (1910); *Denver* v. *Denver Union Water Co.*, 246 U.S. 178 (1918); *Kimball Laundry Co.* v. *United States, supra*, p. 17, Footnote 8.

The fallacy of the decision below is manifested by the statement that the taxpayer "merely substituted stock liability for bonded indebtedness." (Appendix A, p. 9a) This very statement indicates a total lack of understanding or callous disregard of the economic ramifications of corporate capital structure.

5. The decision of the Court below on petitioner's alternative contentions is inconsistent with its own holdings.

In discussing petitioner's alternative contention that if the value of the bonds or of the stock issued therefor are not to be included in equity invested capital, the cost basis of the converting bondholders must be the measure of inclusion pursuant to Section 718(a)(2), the Court of Claims held that even assuming that bonds are property paid in for stock, said basis to the converting bondholders is immaterial as only the basis to petitioner-taxpayer is pertinent. But Section 718(a)(2) and the pertinent Regulations provide that if basis is cost said cost is the fair market value of the *stock issued therefor*. Further, the Court of Claims ignored the point of the alternative argument which is that even if it could be assumed that the conversion had no economic significance, then the stat-

ute requires that the transferor's basis of the property (a substituted basis) be included in equity invested capital. *Walsh Holyoke Steam Boiler Works, supra; The Maltine Co.* v. *Commissioner, supra.*

Conclusion

WHEREFORE, it is prayed that a writ of certiorari be issued to the Court of Claims reversing its decision and remanding the issue for a determination of the amount of going concern value contributed to petitioner upon the conversion of its bonds into stock.

Respectfully submitted,

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APPENDIX A

IN THE

United States Court of Claims

No. 310-62

(Decided October 18, 1968)

UNION PACIFIC RAILROAD COMPANY

v.

THE UNITED STATES

ROBERT J. CASEY, attorney of record, for plaintiff. THOMAS E. TYRE, JOHN A. CRAIG, THOMAS J. McCOY, JR. and CLARK, CARR & ELLIS, of counsel.

THEODORE D. PEYSER, with whom was ASSISTANT ATTORNEY GENERAL MITCHELL ROGOVIN, for defendant. PHILIP R. MILLER and JOSEPH KOVNER, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR PARTIAL SUMMARY JUDGMENT

SKELTON, *Judge*, delivered the opinion of the court:

The plaintiff, Union Pacific Railroad Company, was and has been at all times pertinent hereto, a corporation organ-

ized and existing under the laws of the State of Utah, with its office and principal place of business in New York. It brought this action to recover, among other items, $4,187,-159.68 in income and excess profits tax and assessed interest thereon paid for the calendar year 1942, together with statutory interest thereon, and $9,222,801.78 in statutory interest on refunds or credits of tax previously made for 1942.

Both plaintiff and defendant (The United States of America) have moved for partial summary judgment with reference to the claims set forth in Counts XXIX and XXX of plaintiff's first amended petition. The consideration and disposition of these motions is all that is before the court for decision at this time.

In our opinion decided January 19, 1968, we held that this court had jurisdiction over the issues embraced in these two counts solely as offsets to the defendant's offsets.[1] These issues involve the problem of what should be included in plaintiff's equity invested capital for purposes of determining its excess profits tax credit under the provisions of the World War II Excess Profits Tax Act. It naturally follows that the greater plaintiff's equity invested capital, the more credit it will receive and the less taxes it will have to pay. Under these circumstances, it is to plaintiff's advantage to show as large an amount of equity invested capital as possible. It seeks to do this by the following facts set forth in Counts XXIX and XXX of its amended petition.

In Count XXIX, it is shown that in 1901, plaintiff issued $100 million in ten-year four percent bonds convertible at the option of the holder into $100 par value common stock. The bonds could be converted into or exchanged for stock on the basis of one share of the $100 par value common stock for each $100 principal amount of the bonds. The

[1] *Union Pacific Railroad Co.* v. *United States,* 182 Ct. Cl. 103, 389 F. 2d 437 (1968). See that decision for an over-all statement of plaintiff's entire case, which will not be repeated here.

plaintiff received $100 million in cash for these bonds. From 1901 through 1907, holders of the bonds converted $99,450,000 principal amount of the bonds into 994,500 shares of plaintiff's common stock which plaintiff issued to them on the basis specified in the bonds when they were originally issued (*i.e.,* $100 par value share of stock for each $100 amount of bonds). The plaintiff computed its excess profits tax credit based on equity invested capital for the year 1942 and its unused excess profits carryovers from 1940 and 1941 by including in money and property paid in for the issuance of the 994,500 shares of stock, the sum of $99,450,000. This was approved by the Commissioner of Internal Revenue. However, in its first amended petition, filed herein December 14, 1966, plaintiff claims for the first time that the Commissioner, in computing plaintiff's excess profits tax credit based on equity invested capital, should have included in money and property paid in for stock an additional $28,662,393.68, which is alleged to be the excess of the fair market value of said stock over its par value at the time the bonds were converted into stock.

In Count XXX, plaintiff alleges that in 1907 it issued $73,762,000 in twenty-year four percent bonds convertible at the option of the holder into $100 par value common stock at the rate of one share of stock for $175 face value in bonds. The plaintiff received $73,762,000 in cash for these bonds. During the years 1908 through 1914, the holders of $46,926,775 principal amount of the bonds converted them into 268,153 shares of common stock which were issued to them by the plaintiff for the bonds. (The sum of $46,926,775, divided by the conversion rate of $175, equals the 268,153 shares of stock so issued.) The plaintiff computed its excess profits credit based on equity invested capital for the year 1942 and its unused excess profits carryovers from 1940 and 1941 by including in equity invested capital $175 for each of the 268,153 shares of stock in the total sum of $46,926,775. This was approved by the Commissioner of Internal Revenue.

When plaintiff filed its first amended original petition on December 14, 1966, it claimed for the first time in Count XXX that the Commissioner should have increased plaintiff's money and property paid in for stock, in computing its excess profits tax credit based on equity invested capital for the year 1942, and in computing its unused profits tax credit carryovers from 1940 and 1941 by the excess of the fair market value of the stock so issued over its par value in the total sum of $19,403,421.

In short, the problem before us in the motions is to determine the amount of money or property that was paid in on account of the issuance of the 1,262,653 shares of common stock from 1901 through 1914 by the conversion of the two types of taxpayer's convertible bonds. We might point out that the differences in the two types of bonds are immaterial, because the same principles are involved as to both. We shall, accordingly, treat them for all practical purposes as if they were one type or one issue.

The plaintiff contends that it is entitled to include in its equity invested capital for the purpose of determining its excess profits tax credit under the World War II Excess Profits Tax Act, ch. 757, §201, 54 Stat. 974 (1940), the fair market value of its stock issued in exchange for, and upon conversion of, the bonds issued by it. In the alternative, plaintiff says it is entitled to include in its equity invested capital the fair market value of the bonds converted as of the time of the conversion, and, in the further alternative, their cost to the transferors, who were the last holders of the bonds.

On the other hand, the government contends that the amount to be included in the plaintiff's equity invested capital is the cash paid to the plaintiff at the time the bonds were originally issued and sold. It argues that the conversion did not add anything to or subtract anything from plaintiff's assets, but it merely substituted a stock liability for a debt. It points out that the taxpayer acquired nothing but the converted bonds when it issued the stock and

surrendered nothing but the stock, which was issued at the ratio prescribed in the bonds. The bonds were immediately canceled when plaintiff received them. Defendant says that the value of the bonds and the stock at the time of the conversion is immaterial, because the money paid in for the bonds at the time they were originally issued was the money and property paid in for equity invested capital purposes and nothing more was paid in at the time of the conversion. Both parties agree that the bonds and the stock were of approximately the same value at the time of the conversion. However, both had increased in value many times since the bonds were first issued.

This is a case of first impression on the problem before us. No case has been cited to us, and we have found none, that involves the precise question to be decided here.

The plaintiff bases its case primarily on Section 718(a) of the 1939 Code of Internal Revenue, which is as follows:

> Sec. 718 [as added by Sec. 201, Second Revenue Act of 1940, 54 Stat. 982, and amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798]. Equity Invested Capital.
>
> (a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—
>
> (1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;
>
> (2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the

> property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(*l*) for determining earnings and profits;[2]
>
> * * *

The plaintiff also relies on the following portion of Treasury Regulation 112, Section 35.718-1, which relates to the above-quoted Section 718 of the 1939 Code:

> If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance.[3]

The 1939 Code provides that all provisions of law applicable in respect of the taxes imposed by Chapter 1 of such Code shall be applicable in respect of the tax imposed by Subchapter E (Excess Profits Tax).[4]

Plaintiff contends that for the taxable year 1942 involved here, its basis for loss (unadjusted) is to be determined under Section 113 of the Revenue Code of 1939, which provides:

> Sec. 113. Adjusted basis for determining gain or loss.
>
> (a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; * * *[5]

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[2] 26 U.S.C. 1952 ed., Section 718.

[3] 26 C.F.R., Part 35, Section 718 (1943 Cum. Supp.)

[4] 26 U.S.C. 1952 ed., Sections 728 and 729.

[5] 26 U.S.C. 1952 ed., Section 113.

Accordingly, plaintiff first submits that the basis of the property paid in to it is its cost, namely, the fair market value of the stock issued as consideration for the property received at the time of the conversion. It says that Section 718(a) of the 1939 Code quoted above, defines equity invested capital as (1) "Money" paid in, or (2) "Property other than money" paid in. It argues that at the time of the conversion no money was paid in for the stock, but on the other hand, bonds were paid in for it. It contends that "for the purposes of determining equity invested capital, the bonds must be considered property." It reasons that Treasury Regulations 112, Section 35.718-1, *supra,* provide that the fair market value of the stock at the time of its issuance controls and that such value represents the cost basis of the taxpayer for the bonds it received in exchange for the stock, which basis should be added to its equity invested capital.

We do not agree with plaintiff's application of the provisions of the Internal Revenue Code and the Treasury Regulations to the facts of this case. The plaintiff has made an ingenious argument based on a literal reading of Section 718(a), *supra,* that equity invested capital is either money, or property other than money paid in for stock, and that the bonds were property and not money which were paid in for stock at the time of the conversion. From this, it reasons that according to the Treasury Regulations, its cost basis for the bonds at the time of the conversion was the fair market value of the stock it issued for the bonds. We do not agree that this case can be disposed of by a mere literal reading of the statute and the regulations. It is necessary to go back to the beginning of the transaction and consider all of the facts from that time up to and including the conversion of the bonds for the stock and look at the case from its four corners. The plaintiff would have us consider only what happened at the time of the conversion as if the exchange of the bonds for the stock was a new and independent act with no connection with what had transpired before. This we cannot do, as "the tail

must go with the hide." As a matter of fact, the relationship, rights and obligations of the taxpayer and the bond holders were established when the convertible bonds were issued by the taxpayer in consideration of the cash paid to it by the purchasers of the bonds. The bonds provided that a designated amount of the bonds could be exchanged or converted within a stated period of time by the holders thereof for a fixed amount of stock of the taxpayer. By this means, the values of the bonds and the stock were definitely fixed with relation to each other, and it made no difference in later years whether either or both increased, decreased, or remained unchanged as to fair market value, because the bondholders could always exchange or convert the same amount of stock, regardless of the market value of either or both. The taxpayer was always obligated to issue stock for the bonds at the ratio provided for in the bonds when requested to do so by the bondholders, and could not take any advantage of a fluctuation in the market value of the stock or of the bonds or of both. So, for all practical purposes, the market value of the stock and of the bonds at the time of the conversion was immaterial. The cost of the stock to the bondholders in relation to the bonds had been fixed from the time the bonds were issued and this cost never changed. When the bondholders bought the bonds, they paid cash for them. It was agreed that if the bonds were ever converted into stock, no additional money or payment was to be required of the bondholders. Therefore, for all practical purposes, the original payment of money for the bonds when they were issued became money paid in for stock when the bonds were converted into stock, and such money became a part of the equity invested capital of the plaintiff. This is true as a matter of fact as well as under the provisions of Section 718(a) of the 1939 Code, *supra*.

We agree with defendant that the only money or property paid in for taxpayer's stock was the money originally paid by the purchasers of the bonds. Upon conversion, no additional money or property was paid to the taxpayer for

its stock. The taxpayer further argues that the bonds were property and cites *Victory Glass, Inc.* v. *C.I.R.*, 11 T.C. 656 (1948); *Difco Laboratories, Inc.* v. *C.I.R.*, 10 T.C. 660 (1948); and *Walsh Holyoke Steam Boiler Works, Inc.* v. *C.I.R.*, 160 F. 2d 185 (C.A. 1st, 1947) as authority for this proposition (that bonds and notes are property), and also for the further proposition that their value at the time they were exchanged for stock should be included in equity invested capital. These cases are of no help to plaintiff because none of them involved convertible bonds. It is true as a general proposition that bonds are property, but here the bonds were debts of the taxpayer. Of course, if a taxpayer exchanges its stock for bonds of another company that are not convertible debts of the taxpayer, the above cases would lend support to the taxpayer's argument that the bonds are property and their value at the time of the exchange determines the amount to be included in taxpayer's equity invested capital. But that is not the situation here. In this case, upon the conversion, the taxpayer merely substituted stock liability for a bonded indebtedness. This added nothing to its equity invested capital. We do not agree with taxpayer's alternative argument that it is entitled to include in its equity invested capital the fair market value of the bonds at the time of the conversion.

The plaintiff argues further that by the conversion of the bonds for the stock, the bondholders contributed additional *going concern value* which plaintiff paid for by the issuance of stock therefor and which became an asset of the corporation, and, therefore, should be included in its equity invested capital, although it is an intangible. We hold that Congress never intended this kind of a result in enacting Section 718(a) of the 1939 Code. If the taxpayer corporation had any going concern value, it possessed it before the conversion of the bonds for stock was effected and the conversion had nothing to do with it. To allow plaintiff to add to its equity invested capital by the payment of its bonded indebtedness on the theory that on such payment the creditor-bondholder contributed going concern

value to the taxpayer which became a part of such capital, would be to allow it to include in such capital unrealized appreciation of its assets. This is not permissible. *LaBelle Iron Works* v. *United States,* 256 U.S. 377 (1921).

When the conversion took place, the plaintiff received nothing but the bonds, which it canceled, and gave up nothing but the stock. The conversion added nothing and subtracted nothing from its assets. The effect and result of the entire transaction was that the money originally paid in for the bonds was the money and property paid in for the stock, and this money was all that was added or could be added to taxpayer's equity invested capital. The taxpayer so treated the transaction in its tax returns from 1901 until the filing of its amended petition in this court in 1966, with the approval of the Commissioner of Internal Revenue.

Equity invested capital is limited to funds and property actually invested in the taxpayer's business. Unrealized appreciation of its assets (or losses) cannot form a part of such capital. This was the holding of *LaBelle Iron Works* v. *United States, supra.* That was a case involving invested capital and excess profits tax during the First World War. There the taxpayer increased the value of some of its assets by $10 million, which it carried to surplus, and it then declared a stock dividend by issuing $19.8 million of stock for $9.9 million of its old stock on a par value basis. The court held that such a transaction was in effect a "paper transaction" which did not increase the invested capital of the company since it did not add any new capital to it. In deciding the *LaBelle* case, the Supreme Court explained that the purpose of the World War I Excess Profits Tax, Revenue Act of 1917, ch. 63, 8207, 40 Stat. 300, was to raise money quickly for the war effort, and it noted the reasons Congress chose the language that it did.

> * * * [i]t was the dominant purpose of Congress to place the peculiar burden of this tax upon the income of * * * businesses exceeding what was deemed a nor-

> mally reasonable return upon the capital actually embarked. But if such capital were to be computed according to appreciated market values based upon the estimates of interested parties (on whose returns perforce the Government must in great part rely), exaggerations would be at a premium, corrections difficult, and the tax easily evaded. *LaBelle, supra,* at 387.

Thus, to avoid a practically impossible administrative burden of determining inflated market values and to prevent avoidance of the tax, "the draftsman of the act resorted to the test of including nothing but money, or money's worth, actually contributed * * *." *Id.* at 388

In light of this World War I Act and the *LaBelle* decision, Section 718, *supra,* was adopted. The problems of determining inflated values and the desire to prevent avoidance of the tax were as great when this section was adopted as in 1917, and again Congress chose a restricted definition of "invested capital." If anything, contrary to plaintiff's argument that Section 718 is less restrictive than the World War I Act, the World War II Act definition narrowed the scope of the earlier definition. Section 207 of the Revenue Act of 1917 included in its definition of "invested capital"—

> (a) * * * (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment * * * and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year * * *. [Revenue Act of 1917, ch. 63, § 207, 40 Stat. 306.]

while Section 718, *supra,* did not include in its definition "undivided profits used or employed in the business." See Section 718, Revenue Code of 1939, *supra.* There is nothing

in the language of Section 718 to indicate that Congress attempted to broaden the scope of the earlier act or to overturn or restrict the *LaBelle* decision. Therefore, we think that any discussion of the World War II Act must take account of *LaBelle* and conclude that it is applicable to World War II excess profits tax cases such as the case at bar.[6]

In the case at bar, the conversion of the bonds for the stock was nothing but a paper transaction that was carried out in accordance with the provisions of the convertible bonds. No new or additional capital was acquired by the taxpayer. While the *LaBelle* case did not involve convertible bonds, it illustrates that a taxpayer cannot increase its equity invested capital by the unrealized appreciation of its assets. Such capital can be increased only by the payment or transfer of new money or property to the taxpayer that can be properly considered working capital. This court said in *American Radiator & Standard Sanitary Corp.* v. *United States*, 155 Ct. Cl. 515, 521, 295 F. 2d 939, 942-943 (1961):

> Certainly, to be considered "property" for tax purposes, the rights received by a taxpayer must be of such vested character as to be properly considered *working capital.* [Emphasis supplied.]

The conversion of the bonds here added nothing to the working capital of the taxpayer.

The Tax Court has applied the principles of the *LaBelle* case in two World War II excess profits tax cases where it excluded from equity invested capital unrealized apprecia-

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[6] See *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950); *Reynolds Spring Co.* v. *Commisisoner*, 181 F. 2d 638, 640 (C.A. 6th, 1950), *cert. denied*, 340 U.S. 821 (1950); *Gabriel Co.* v. *Commissioner*, 186 F. 2d 786, 794 (C.A. 6th, 1951), *cert. denied*, 341 U.S. 950 (1951); *Bard-Parker Co.* v. *Commissioner*, 218 F. 2d 52, 58 (C.A. 2d, 1954), *cert. denied*, 349 U.S. 906 (1955); *Western Maryland Railway Co.* v. *United States*, 227 F. 2d 576, 578 (C.A. 4th, 1955), *affirming* 131 F. Supp. 873, 897 (Md., 1955), *cert. denied*, 351 U.S. 907 (1956).

tion of assets where the taxpayers increased the value of the capital stock above the amount of money originally paid in for the stock.[7]

In 1919, the Bureau of Internal Revenue issued a ruling under Section 326 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, which defined invested capital as follows:

> Section 326, Article 831: Meaning of invested capital.
>
> Where bonds are exchanged for stock in the same corporation under the terms of a convertible trust deed, it will be presumed, for the purpose of computing invested capital, that the value of the bonds is equivalent to the value of the stock. The addition to invested capital would accordingly be the amount for which the bonds were originally sold.[8]

This definition of invested capital is in accord with our view of this case and is applicable here even though this ruling was issued before the enactment of the World War II Excess Profits Tax statute. The addition to invested capital of the taxpayer was "the amount for which the bonds were originally sold."

Revenue Ruling I.T. 2347, VI-1 Cum. Bull. 86 (1927) stated:

> When a corporation retires its bonds and converts them into stock, the issuing price of such stock, so far as the corporation is concerned, will be considered to be the issuing price of the bonds plus the amount of amortized discount previously taken as a deduction by the corporation.

See also G.C.M. 9674, X-2 Cum. Bull. 354 (1931) and T.D. 4603, XIV-2 Cum. Bull. 58 (1935), which are substantially to the same effect.

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[7] See *Home Guaranty Abstract Co.* v. *Commissioner*, 8 T.C. 617, 621 (1947); and *L. A. Dreyfus Co.* v. *Commissioner*, decided October 31, 1949, 8 CCH Tax Ch. Mem. 972 (1949).

[8] O.D. 306, 1919 Cum. Bull. 283.

In the case of *Liquid Carbonic Corp.* v. *Commissioner*, 34 B.T.A. 1191, 1196 (1936), the Board of Tax Appeals held:

> * * * the conversion of bonds into capital stock of the obligor is purely a capital transaction; that is, a readjustment of the obligor's capital structure, which does not result in either a deductible loss or a taxable gain. The obligor does not pay out anything. It merely readjusts its capital. As we said in *375 Park Avenue Corporation, supra,* [23 B.T.A. 969], "Instead of suffering the outlay of money in excess of the amount borrowed, it created a new distribution of its shares, thus avoiding its fixed financial obligation and devoting the borrowed money to the ordinary risks of its business."

The taxpayer makes the further contention that if it cannot include in its equity invested capital the value of the stock or the value of the bonds at the time of the conversion, it should be allowed to include in such capital the cost basis of the last owners of the bonds who surrendered them for conversion. This argument is made on the theory that the bonds were property paid in for stock and is based on the fact that some of the bonds changed hands many times between the time of their original issuance and the conversion and at much higher prices than were originally paid for them. This contention must fail because we are not concerned with the cost basis of the transferors, but only with the basis of the taxpayer. These bonds were debts of the taxpayer on which it had borrowed the amounts originally paid for the bonds. That was its basis and that is what was included in its equity invested capital. It matters not how many times the bonds changed hands nor how much the price increased for each sale of them prior to conversion, because none of the increased price was paid to taxpayer and consequently could not be included

in its equity invested capital. Even if it could be said *arguendo* that the bonds were property paid in for stock at the time of conversion, all that could be included in plaintiff's equity invested capital under Section 718(a) and Section 113 of the 1939 Code was its cost or basis and not the cost or basis of the last transferor. The cost or basis of the plaintiff was the amount originally paid in for the bonds.

It is our view and we hold that all that was ever included in plaintiff's equity invested capital by the issuance of the convertible bonds and their conversion into taxpayer's stock was the money paid in for the bonds when they were originally issued.

Accordingly, plaintiff's motion for partial summary judgment as to Counts XXIX and XXX of its first amended petition is denied, and defendant's motion for partial summary judgment as to such counts of said petition is granted with the petition dismissed as to them. The case is remanded to the trial commissioner for further proceedings.